Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:1:TL-N-7123-00
JEKagy

date:

to: Team Manager Neil Gilday (MCT)
Attn: Ron Meyer

from: RICHARD E. TROGOLO
Associate Area Counsel (LMSB)

subject: [redacted]
Potential Section 332 Issue

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This responds to your November 28, 2000 memorandum seeking our comments on two theories proposed by Examination for the disallowance of losses claimed by [redacted] on the liquidation of several its foreign subsidiaries. Earlier, in October, 2000, we responded to an inquiry regarding the Service's authority to question the legitimacy of the losses. Our earlier memorandum (copy attached) concluded that while it was premature to suggest that facts would be found supporting the disallowance of the losses claimed, the Service had the right to scrutinize the steps utilized to accomplish corporate liquidations to determine whether the form chosen by the taxpayer comported with the substance of the transactions.

Your November 28, 2000 memorandum forwarded two Forms 5701, Notices of Proposed Adjustment, which proposed the disallowance of the claimed losses based on two theories. By your memorandum, you sought our review of the litigation potential of the theories.

ISSUES:

1. Whether the facts support the conclusions that the transactions were shams and that the reduction of the taxpayer's ownership below 80% was illusory.

2. Whether the term "owner", as used in section 332(b)(1), may be interpreted to include the aggregation of <u>all</u> corporations meeting the 80% voting power and 80% of the total voting power tests, not just the corporations within the affiliated group.

CONCLUSION:

1. We believe that the facts developed to date fail to justify the conclusions that the transactions were shams and that the reduction of the taxpayer's ownership below 80% was illusory.

2. We believe that the Service has interpreted the term "owner", as used in section 332(b)(1), to mean the aggregation of only those corporations within the affiliated group meeting the 80% voting power and 80% of the total voting power tests of Treas. Reg. § 1.1502-34.

FACTS:

Prior to [redacted], [redacted] directly and, through its domestic subsidiaries, indirectly owned [redacted]% of [redacted] ("[redacted]"), a Brazilian holding company, which in turn owned [redacted]% of a Brazilian operating company known as [redacted] ("[redacted]"). In [redacted], [redacted] issued new voting stock to [redacted] ("[redacted]"), a Canadian subsidiary owned [redacted]% by [redacted]. The newly issued stock diluted [redacted]s direct and (domestic) indirect ownership interest in [redacted] to [redacted]%. In [redacted], Investments purchased newly issued voting stock in [redacted] ("[redacted]") another Brazilian holding company formerly indirectly owned [redacted]% by [redacted]. [redacted]' purchase diluted [redacted]'s ownership interest in [redacted] to [redacted]%. In [redacted], [redacted] purchased newly issued voting stock in [redacted], further diluting [redacted]'s direct and indirect ownership in [redacted] to [redacted]%. Several days later, [redacted] was liquidated.

The only asset owned by [redacted] was its [redacted]% interest in the stock in [redacted] In addition to its $[redacted] initial equity interest in [redacted], [redacted] had "loaned" [redacted] $[redacted]. While reflected on [redacted]'s Brazilian books as a loan, the $[redacted] was carried on the U.S. books for GAAP and tax purposes as an additional capital contribution. An appraisal of [redacted] reflected a value on the date of [redacted]' liquidation of only $[redacted] [redacted]'s basis in [redacted] was approximately $[redacted]. Upon [redacted]' liquidation, [redacted] was treated as having received its proportional share of the value of [redacted] [redacted] claimed a loss of $[redacted] on the liquidation of [redacted], calculated as the difference between its basis in [redacted] and the value received upon liquidation.

In June, 1996, [redacted] was also liquidated. [redacted]'s only asset was its [redacted]% equity interest in [redacted], an equity interest which had a cost basis to [redacted] of $[redacted]. In addition to its initial equity interest in [redacted], [redacted] had "loaned" [redacted] approximately $[redacted]. [redacted] reflected this amount on its Brazilian books as a loan, but the "loan" was carried on the U.S. books for GAAP and tax purposes as an additional capital contribution. An appraisal of [redacted] reflected a value of $[redacted] on the date of [redacted]'s liquidation. [redacted]s basis in [redacted] was approximately $[redacted]. Upon [redacted]'s liquidation, [redacted] received only its proportional share of the value of [redacted] and [redacted] claims a loss of $[redacted], calculated as the difference between its basis in [redacted] and the value received upon its liquidation.

REVENUE AGENT'S POSITION:[1]

ISSUE 1:

As of [redacted], [redacted] months prior to the liquidation of [redacted] and [redacted], [redacted] months prior to the liquidation of [redacted], [redacted]% of the stock of both companies was owned either directly or indirectly, by [redacted] As a result, if the liquidations of the two companies had occurred at that time I.R.C. § 332 would apply and no gain or loss would be recognized. Consequently the taxpayer would not be able to recognize the $[redacted] capital loss. It is the transactions that took place after [redacted] that must be looked at. If those transactions were real transactions with a business purpose that results in [redacted] no longer owning [redacted]% of the stock of either of the liquidated companies, then the loss should be allowed. If those transactions are nothing but

[1] For an exact statement of the revenue agent's position, refer to the Forms 5701 attached.

illusory or transitory then they should be ignored and no loss would be allowable.

The case law for transactions designed to bring a taxpayer below the 80% threshold of I.R.C. § 332 is long. There are a great number of cases where the courts have ruled that a taxpayer did in fact no longer own 80% of the stock and was not required to recognize any gain where some portion was sold to a 3rd party. Commissioner v. Day & Zimmermann, Inc, 151 F.2d 517 (3rd Cir. 1945) and Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) are two adjudicated cases where the court ruled for the taxpayer. In Day & Zimmermann the court ruled that the requisite disposition was made to the treasurer of the company. In Granite the required stock sale was made to a company picked by the taxpayer with which agreements had been made in advance that the stock would be voted in a friendly manner toward the taxpayer. But, in these two cases, as in every single case, there is one common thread that runs through them. In every case won by the taxpayer the requisite disposition was made to an unrelated 3rd party. The courts have consistently ruled that an actual disposition to an unrelated third party, no matter how tenuous, results in an avoidance of I.R.C. § 332.

In the instant case, all transactions have taken place between companies that are directly [redacted]% owned by [redacted]. At no point has [redacted]% control ever left [redacted].

As the taxpayer interprets the Code, no stock of a foreign company is to be included in determining the total owned. [redacted]'s domestic subsidiaries' total attributable interests amounted to [redacted]%, well below the 80% required to trigger I.R.C. § 332.

An analysis of the steps taken show that the substance of the transactions does not meet the form. The liquidated corporations had no outstanding debt that needed to be satisfied or expenses that required cash. There was no business purpose or need for the additional stock issuance other than to reduce [redacted]'s attributable share of total ownership below the I.R.C. § 332 threshold.

Based upon the foregoing, the agents concluded:

> The transactions are a sham and the reduction of taxpayer's ownership below the 80% level in illusory. Consequently all the stock should be attributed to [redacted]. As such I.R.C. § 332 would apply and no loss would be deductible.

ISSUE 2 (Revenue Agent's Alternative Position):

The taxpayer relies on I.R.C. § 1504 which defines "affiliated group" and the stock attribution rules for affiliated groups. Under section 1504 an affiliated group does not include a foreign corporation and any stock owned by the foreign corporation is not attributable to any other member of the affiliated group.

Before being amended I.R.C. § 332 contained the language that established the 80% stock rule. Nowhere in that section was any reference made to an affiliated group, nor does it define what stock attribution rules are to be used to determine total stock ownership. After amendment the section reads "...on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock in such corporation meeting the requirements of section 1504(a)(2)." Section 1504(a)(2) reads "80-percent Voting and Value Test - The ownership of stock of any corporation meets the requirements of this paragraph if it - (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and (B) has a value equal to at least 80 percent of the total value of the stock of such corporation." I.R.C. § 332 still makes no mention of "affiliated group". It references section 1504 to describe the amount of stock that must be owned for section 332 to apply, but it does not state how that 80% is to be determined.

If Congress had intended that only stock of an includible corporation of an affiliated group were to be included it could have referenced the stock attribution rules for affiliated groups at I.R.C. § 1504(a)(1). No such reference is made.

Treas. Reg. § 1.1502-34 addresses ownership and attribution of stock owned by members of a group. It says that in determining I.R.C. § 332(b)(1), the 80% rule, all stock owned by members of a group is owned by all other members of the group. Again, the term "group" is referenced. Had Congress intended to limit the application of this to "affiliated groups" the term affiliated groups would have been referenced.

Rev. Rul. 89-46 addresses whether the stock of one member of an affiliated group can be attributed to another member of the affiliated group when no stock of either is owned by the other. The ruling states that Treas. Reg. § 1.1502-34 applies and the stock owned by each is attributable to all members of the affiliated group. While this revenue ruling deals with affiliated groups it does not state that Treas. Reg. § 1.1502-34 is only applicable to affiliated groups.

With no direct guidance we must look at the Congressional record and Congress' intent. It is a long established fact that Congress does not want any loss deducted on liquidation for a company owning 80% of the liquidating entity. If it were to be inferred that Congress actually intended that only stock of an affiliated group to be included in the 80% total, it would completely negate I.R.C. § 332. Any company could incorporate a foreign corporation and use that company to buy or sell stock of an otherwise controlled corporation. If they did not want I.R.C. § 332 to apply, they would simply need to increase the foreign corporation's stock holding, and if the desire was to make section 332 apply reduce the stock holding. Such an allowance would completely negate Congress' intent. Losses would always be deductible and gains would never be taxable.

This is addressed in the Congressional record for Treas. Reg. § 1.1502-34. The record states that Treas. Reg. § 1.1502-34 is to apply even if one or more of the companies are not includible companies. This statement recognizes the dilemma created by only counting stock of includible companies in an affiliated group. The possibility of manipulation of I.R.C. § 332 is removed as Treas. Reg. § 1.1502-34 is to apply to all members of the group.

Based upon the foregoing, the revenue agent concludes that all of the stock is attributable to [redacted]. As such the taxpayer owns in excess of the 80% threshold of I.R.C. § 332. Therefore, no loss is allowable.

ANALYSIS:

ISSUE 1:

The agents place significant importance on what they saw as the common thread running through all cases won by the taxpayer, where the applicability of section 332 was at issue, i.e., the fact that the taxpayer's sale of its interest in the subsidiary was to a third party.

In our opinion, the fact that the divestitures were to unrelated parties was not crucial to any of the decisions. That a sale was to a related party would only have caused the court to examine the bona fides of the transaction with closer scrutiny. The analysis, however, would have been the same.

For instance, in Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956), the taxpayer took affirmative steps to avoid the 80% ownership requirement on section 112(b)(6), the predecessor of section 332. While the sales took place between unrelated parties, the "friendly atmosphere between friendly parties" caused the government to argue, inter alia, that the sales in question did not, in fact, take place. The government argued that the sales were not bona fide and that the seller retained a beneficial interest in the stock sold. Because of those arguments, the Court addressed at length the issue of whether the sales were valid and whether the substance of the transfers comported with the form chosen. The Court examined the purported sales for "any evidence indicating an understanding by the parties to the transfer that any interest in the stock transferred was to be retained by the taxpayer." Granite, 238 F.2d at 677. As a result of that examination, the Court concluded as follows:

> [because the facts] show legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be, [the sales must be given their effect].

Granite, 238 F.2d at 678.

Similarly, in Commissioner v. Day & Zimmermann, 151 F.2d 517 (3rd Cir. 1945), where the connection between the buyer (the taxpayer's treasurer) and the seller was clearly apparent, the Court went to great lengths to verify the bona fides of the transaction, the implied and explicit understandings between the parties, and the existence or lack of retained benefits in the stock in the hands of the seller. Day & Zimmermann, 151 F.2d at 519. As a result of that analysis, the Third Circuit concluded:

> [T]he facts before us so manifestly point to the legitimacy of the ... purchase of stock that they offer no alternative but to accept that view of the transaction.

Id.

Nor would the analysis have been different if the buyer and seller had been corporations related by common ownership. The Service does not have the option of collapsing the transaction or the parties thereto simply because the parties are related. As a general rule, the Service must respect the existence of the separate corporations. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). A corporation remains a separate taxable entity for tax purposes so long as its purpose is the equivalent of a business activity or is followed by the carrying on of a business by the corporation. Moline, 319 U.S. 439. According to Moline Properties, a corporation is a separate taxable entity even if it has only one shareholder who exercises total control over its affairs. So long as a corporation carries on a business activity, the fact that the owner retains direction of its affairs down to minutest detail, provides all of its assets and takes all of its profits, can make no difference tax-wise. See, e.g., Commissioner v. National Carbide Corporation, 167 F.2d 304, 307 (2d Cir. 1948), aff'd, 336 U.S. 422 (1949).

It is axiomatic that the question of whether a corporation is carrying on a sufficient business activity to permit its recognition as a separate entity for tax purposes is a matter of fact for which the taxpayer bears the burden of proof. See, e.g., Bass v. Commissioner, 50 T.C. 595, 602 (1968). Nevertheless, given the facts portrayed above, it is undeniable that the corporations at issue had been carrying on legitimate business activities for years.

The fact that the instant transaction took place between related parties does not establish, by itself, that the transaction was a sham or that the separate corporate nature of the parties should be ignored. The relationship between related parties, while inviting increased scrutiny, still requires the Service to explore and verify the bona fides of the transaction, the implied and explicit understandings between the parties, and the existence of any retained benefits in the stock in the hands of the seller. It is only when the factual analysis determines that the legal transactions are fictitious and so lacking in substance as to be something different from what they purport to be, that the sales must be denied their contrived effect.

Here, the revenue agent's conclusion that the taxpayer had no business purpose does not seem well taken. There is no indication that the taxpayer was asked for its business purpose for the transaction, or that the taxpayer refused to provide a response. It seems to us that during the middle 1990's, the sum of the taxpayer's whole business, domestic and international alike, was being consolidated, streamlined or "right sized". If our recall of the business climate within which the taxpayer was operating is correct, a natural business purpose for the transaction existed. We seriously doubt that a taxpayer of this size and tax savvy would fail to devise a legitimate nontax purpose for activities which are as obvious as those before us.

From the facts provided to us, we see insufficient evidence to establish the conclusion that the transactions were shams and that the reduction of the taxpayer's ownership below 80% was illusory.

ISSUE 2:

During 1996 and 1997, section 331 provided that amounts received by a shareholder in complete liquidation of a corporation would be treated as the full payment in exchange for the stock. Section 332(a) further provided that there was no gain or loss to be recognized on the receipt by a corporation of property received in complete liquidation of another corporation. Section 332 also set forth the criteria which must be satisfied in order for a distribution to be considered a "complete liquidation."

Of the noted requirements, it is necessary to focus on the section 332(b)(1) requirement that:

> [T]he corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the **owner** of stock (in such other corporation) meeting the requirements of section 1504(a)(2); (Emphasis added.)

Section 1504 is a section of definitions. Section 1504(a)(1) defines the term "affiliated group" to be a chain of includible corporations[2] to the extent ownership of the corporations meets one of two standards. First, the includible corporations may meet the definition of affiliated group if the common parent directly meets the 80% test of section 1504(a)(2) in such corporations. The includible corporations may also meet the definition of affiliated group if stock meeting the section 1504(a)(2) rule in each includible corporation is directly owned by one or more other includible corporations.

Section 1504(a)(2), which sets forth the "80% voting and value test" for determining ownership of corporate stock, reads as follows:

> The ownership of stock of any corporation meets the requirements of this paragraph if it--
>
> > (A) possesses at least 80 percent of the total voting power of such corporation, and

[2] By definition, the term "includible corporation" may NOT include foreign corporations. See section 1504(b)(3)

> (B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

The meaning of the term "owner" as used in section 332(b) has been called into question by the revenue agent. According to the agent, section 332 refers to section 1504 to describe the amount of stock that must be owned for section 332 to apply, but section 332 does not state how that 80% is to be determined. Based primarily on a reading of the statute and the legislative history, the agent posits that the term "owner" should mean the corporation and the aggregation of interests of all corporations, domestic and foreign alike, which are owned by the parent corporation under the "80% voting and value test." In other words, the agent would define the term "owner" to include not only the corporation's direct ownership but also the aggregation of the ownership interests held by all foreign and domestic corporations which are themselves owned by the parent under the 80% voting and value test of section 1504(a)(2).

Initially, we commend the agent's originality and effort in developing a novel argument. As it stands, however, we cannot support the agent's position. At first blush, it was necessary to question why any ownership interests beyond those directly owned by the receiving corporation would be considered. In other words, from the agent's write up, it was not clear why any aggregation was necessary. Facially, sections 332 and 1504 appear to combine to provide that only if the receiving corporation, itself, owns 80% of the liquidation corporation, then no loss or gain shall be recognized on the liquidation. Without more guidance, it is at least equally arguable that <u>no</u> aggregation would be permitted or required when applying section 332.

That argument is easily dispensed with by Treas. Reg. § 1.1502-34 (part of the legislative consolidated return regulations), which states, in pertinent part:

> For purposes of §§ 1.1502-1 through 1.1502-80, <u>in determining the stock ownership of a member of the group in another corporation</u> (the "issuing corporation") for purposes of determining the application of section 165(g)(3)(A), <u>**332(b)(1)**</u>, 333(b), 351(a), or 904(f), in a consolidated return year, there shall be included stock owned by all members in the group in the issuing corporation.

The forgoing regulation has been in existence since 1966 (<u>see</u> Treasury Directive 6894), long before the current language of section 332(b) was changed to incorporate the 80% voting and value test of section 1504. Clearly for purposes of the filing of its consolidated return, the aggregation rules apply for purposes of section 332(b)(1).

While the agent suggests that there is nothing which specifically restricts the application of Treas. Reg. § 1.1502-34 to only affiliated corporations, we disagree. Treas. Reg. § 1.1502-34, by its very wording and nature, is restricted to consolidated returns and therefore affects only affiliated corporations.

Moreover, Treas. Reg. § 1.1502-1 specifies that the term "group" means an affiliated group of corporations and notes that references to a "group" are references to a consolidated group. The use of the term "group" throughout the consolidated return regulations must, absent specific language to the contrary, carry the defined meaning of the term, that is, the affiliated or consolidated group. Since foreign corporations are not includible corporations and may not be part of the consolidated or affiliated group, references to the term group cannot include foreign corporations.

We conclude that the application of the Treasury regulations requires that the 80% test for ownership be applied to members of the affiliated or consolidated group, necessarily excluding foreign corporations. While this permits corporate taxpayers to plan whether they will recognize gains or losses on complete liquidations of subsidiaries, as a general matter, it appears to us that as long as the taxpayer has a valid business reason for the transaction and the substance of the transaction comports with its form, the Service must accept the legitimacy of the transaction. This acceptance, however, is predicated on the Service satisfying itself that the business purpose is legitimate, the steps anticipated actually occur and have real substance to them, and that the substance of the transaction comports with its form.

In that regard, we refer your attention to a quote from <u>Associated Wholesale Grocers, Inc. v. United States</u>, 927 F.2d 1517 (10th Cir. 1991), which discusses just this point:

> Section 332 is not elective. Nonetheless, a number of planning possibilities are evident which may allow a corporation to avoid the application of Section 332. 11 J. Mertens, <u>The Law of Federal Income Taxation</u> § 42.55 at 142 (1990). Steps taken by the taxpayer, however, are not immunized from '[t]he question ...

> whether the transaction under scrutiny is in fact what it appears to be in form.'

Associated Wholesale Grocers, 927 F.2d at 1525.

We hope the foregoing fully addresses the questions which were raised, but if additional questions remain, please contact the undersigned at ext. 3211.

RICHARD E. TROGOLO
Associate Area Counsel
(Large and Mid-Size Business)

By:______________________________
JAMES E. KAGY
Special Litigation
Assistant

Attachments:
As stated.